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Uncharitable Treatment? Why Donations to Private and Public Foundations Deserve Equal Tax Status

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Canada's public foundations and charities got a helping hand from Ottawa last year when the May federal budget removed the capital gains tax on listed securities given as donations. While the change facilitated gifts of stock to these public organizations, their philanthropic cousins, private foundations, did not benefit. This differential treatment potentially discourages donations to, and the development of, private foundations (Payne 2005).

Why should anyone but wealthy donors care? Private foundations are a mainstay of Canada's charitable sector. There are more than 3,000 private foundations in the country, with annual donation receipts totaling more than $700 million, compared to about 4,000 public foundations that receive perhaps twice as much in total donations. Private foundations are a means of leaving a legacy of philanthropy. Their differential tax treatment reflects a general assumption that they engage in more non-arm's length transactions and are therefore more susceptible to tax abuse. A closer look at the flow of funds in private versus public foundations, which we undertake in this paper, helps assess the distinction.

What are the issues? The 2006 federal budget announced that the government would consult with private foundations and the charitable sector to develop self-dealing rules. If appropriate rules were devised, Ottawa would be prepared to bring these rules before Parliament within a year and would seek to extend the capital gains exemption for donations of listed securities to private foundations.[1] We support this undertaking and encourage the government to restructure the oversight of private foundations to provide for their development, while discouraging potential abuses of the private foundation structure.

1 "Federal Budget Plan 2006: Focusing on Priorities," May 2, 2006, p. 123. Available at http://www.fin.gc.ca/budget06/pdf/bp2006e.pdf.

How has the tax benefit for donated securities evolved?

The May 2006 budget marked the third time in the last decade the government has increased the tax benefit for donated securities. However, private foundations only benefited from one of these three changes (summarized below). Prior to any of the changes donors had to recognize 75 percent of the capital gains on any stock donated to a charity.

- The first reduction — the half-inclusion rate — was announced in the 1997 budget. Thereafter, the portion of capital gains (embodied in securities donated to charitable organizations and public foundations) was one-half of the taxable amount the gains might otherwise have generated, reducing the rate to 37.5 percent.[2]
- The second reduction on the level of capital gains recognized was introduced in 2000 for all types of charities including private foundations. The 2000 federal budget reduced the general capital gains inclusion rate from three-quarters to two-thirds as of February 28, 2000, and from two-thirds to one-half as of October 18, 2000.[3] For donations to private foundations, the level was reduced from 75 percent to 50 percent.[4] For donations to charitable organizations and public foundations, the capital gains inclusion rate was further reduced to 25 percent with the "half-inclusion rate" measure applied.
- After the most recent change, donors of securities to registered charities, including public but not private foundations, pay no capital gains tax on donated stock.

Why the differential tax treatment?

A foundation is deemed a private foundation by the *Income Tax Act* (ITA) based on who controls the foundation and the source of assets (see Table 1). If a foundation is controlled by non-arm's length individuals, goes the general presumption, there is a higher probability of potential abuse of the tax system. The ITA provisions for private foundations differ from those for public foundations in many aspects,[5] and this difference potentially discourages private foundations' development as a vehicle for supporting the charitable sector.

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2 The *Income Tax Act*. Para. 38(a.1).

3 "Federal Budget Plan 2000: Better Finances, Better lives," February 28, 2000, p. 94. Available at http://www.fin.gc.ca/budget00/pdf/bpe.pdf.

4 The *Income Tax Act*. Para. 38(a.2).

5 See Payne (2005) for more details on the different treatments of public and private foundations.

Table 1: *The Differences between Public and Private Foundations*

	Public Foundation	Private Foundation
Definition [a]	A registered charity is designated as a public foundation if: (a) it is constituted and operated exclusively for charitable purposes; (b) it is a corporation or a trust; and (c) it gives more than 50% of its income annually to qualified donees, usually other registered charities. It must also meet the following two conditions: (1) more than 50% of its directors/trustees deal with each other and with each of the other directors/trustees at "arm's length" [b] (2) not more than 50% of the funds that the charity has received have come from one person or organization, or from a group of people or organizations that do not deal with each other at arm's length.	A registered charity is designated as a private foundation if: (a) it is constituted and operated exclusively for charitable purposes; (b) it is a corporation or a trust; and (c) it is not a "charitable organization" or a "public foundation." An entity is designated as a "private foundation" rather than a "charitable organization" or a "public foundation" because of the extent to which those who fund or control it are not operating at arm's length.
Funding source	Most funding from the general public or the government.	Principal funding usually from a single source, such as an individual or a family.
Management and operation	Managed and operated by staff and volunteers that are much more likely dealing with each other and with the donors at arm's length.	Usually managed by trustees or directors dealing with each other at non-arm's length.
Advantages	A simple and easy option for donors to give any amount of donations.	Named foundation assures legacy in perpetuity. Donors have control over the donations to pursue their own philanthropic objectives.
Tax treatment	100% capital gains exemption for donated listed securities. May issue tax receipts for donations of non-qualifying securities.[c] 25% taxable capital gains on donated appreciated property.	50% taxable capital gains for donated listed securities. More restrictions on issuing tax receipts for donations of non-qualifying securities. [d] 50% taxable capital gains on donated appreciated property.

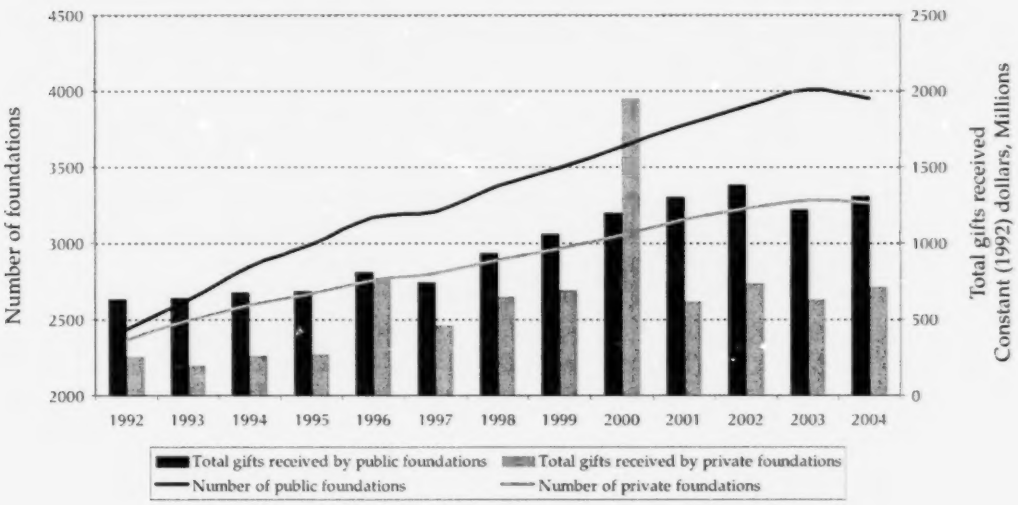
Notes: [a] For definitions of public and private foundations see "Registered Charities and the *Income Tax Act*" available at http://www.cra-arc.gc.ca/E/pub/tg/rc4108/README.html.

[b] The term arm's length is a tax concept describing a relationship in which the parties act independently of each other.

[c] Public foundations may issue tax receipts for non-qualifying securities if the security is in the form of a share and the donor deals at arm's length with the foundation and with each board member of the foundation.

[d] A tax receipt can be issued by private foundations only when — within five years of the receipt of the donation — the foundation sells or disposes of the security, or it ceases to fall within the definition of a non-qualifying security, such as when a private company becomes public.

Figure 1: *Number of Foundations by Type and Total Gifts Received, 1992–2004*



Source: Canada Revenue Agency, unpublished data, and Public Economics Data Analysis Laboratory, Department of Economics, McMaster University.

Are private foundations losing ground?

We looked at information from foundations' returns filed with the Canada Revenue Agency (CRA) between 1992 and 2004, excluding foundations designated as churches or religious organizations.[6] The number of public foundations has grown faster than private foundations (Figure 1, left axis). Since 1992, public foundations grew at a rate about 24.8 percent faster than private foundations, raising the question of whether the tax treatment of private foundations has hampered their growth in numbers and in assets. Over most of the past decade, public foundations received more private donations than private foundations (Figure 1, right axis),[7] and the gap between the donations received by all public versus private foundations has widened.

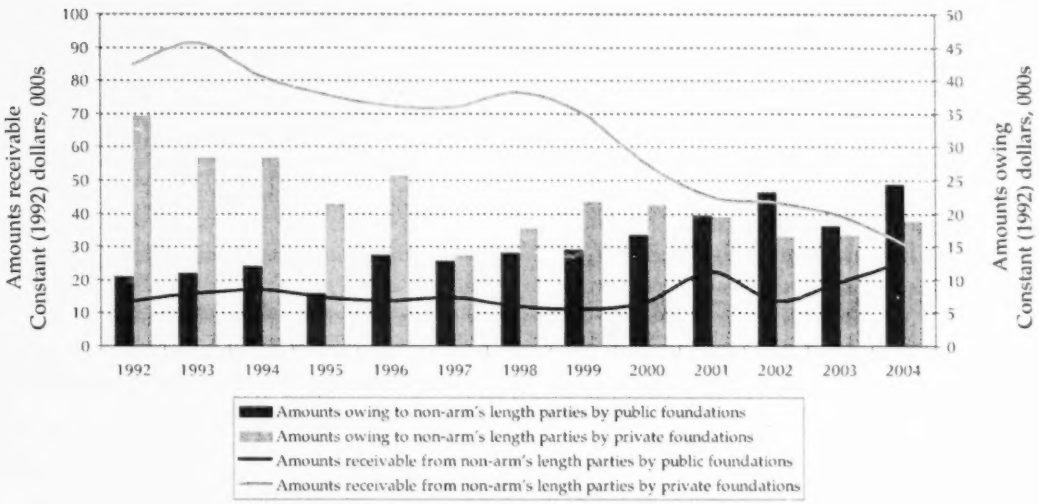
Do non-arm's length transactions make the difference?

As discussed above, one of the strongest arguments for differential treatment of private and public foundations is the notion that if a foundation has more non-arm's length transactions or control, there is room for abuse.

6 The form "T3010 Registered Charity Information Return" changed once during the sample period (in 2003). Please be advised that some of the financial measures are reported differently after 2003. Please also note that all religion-related charitable organizations are excluded from analysis in this brief.

7 The exception in year 2000 is due to a big donation to one private foundation. A private foundation named "Foundation Lucie et André Chagnon" was established with an initial donation of $1.2 billion, which represents 40 percent of that year's total revenue of all private foundations.

Figure 2: *Average Amounts Receivable From and Owing To Non-Arm's Length Parties, by Foundation Type, 1992–2004*



Sources: Canada Revenue Agency, unpublished data, and Public Economics Data Analysis Laboratory, Department of Economics, McMaster University.

Foundations' information returns provide data about amounts receivable from non-arm's length parties and amounts owing to non-arm's length parties.[8] There does not seem to be a clear distinction between public and private foundations with respect to these measures, raising the question of why private foundations are subject to a higher degree of regulatory scrutiny.

Consider the annual average amounts receivable from, and owing to, non-arm's length donors per foundation, shown in real dollars in Figure 2. In real dollars, private foundations reported an average of $84,951 in 1992 and $30,882 in 2004 amounts receivable from non-arm's length parties — a change from 5.6 percent of assets at the beginning, to 1.2 percent at the end of the period. Public foundations generally have a smaller amount receivable from non-arm's length relationship. This amount has been increasing (also in Figure 2) in the last several years for public foundations and has decreased for private foundations.

Based on these measures, few strong differences appear between public and private foundations. The decrease in the amounts receivable from non-arm's length parties for private foundations is most likely caused by the "loan-backs" tax imposed on all charities in 1997, which aims to prevent the assets of charities from being used by non-arm's length parties. Given that private foundations are already

8 After the change of the form "Registered Charity Information Return" in year 2003, there is one additional variable related to non-arm's length parties — "Investments in non-arm's length parties." On average for years 2003 and 2004, 101 out of 3,979 public foundations and 169 out of 3,269 private foundations reported a positive amount for this measure. For those with a positive amount reported, the average amount of "investments in non-arm's length parties" is $965,557 per public foundation and $2,728,744 per private foundation in real dollars.

governed by a loan-back penalty tax and additional regulatory scrutiny, the higher capital gains tax on donations of listed securities to private foundations may lack a clear purpose.

Recommendations

In its December 2006 report, the Standing Committee on Finance recommended that "the federal government amend the *Income Tax Act* to eliminate, on a five-year trial basis, the capital gains tax on donations of publicly listed securities and ecologically sensitive lands to private foundations. The extent to which charitable giving to these foundations has increased should be assessed after five years, and the measure should be made permanent if suitable." [9]

We also recommend regulatory changes to make foundations' activities more transparent. Balanced against this transparency, however, is the need for these regulations to be cost effective in administration and compliance. For example, information on substantial financial transactions with individuals or organizations that are closely related to the foundation should be accessible to the public. The nature of the relationships and any financial transactions between a foundation and its directors, officers, employees, contractors, and donors should be publicly available.

Private foundations not only support current charitable activities, they serve as bedrock for future funding of these activities. Because private foundations play this important role in Canadian society, government policies should facilitate, not discourage, their development. Current government policies should encourage charitable giving, by putting private and public foundations on level ground: charitable giving is no place for tax policy to play favorites.

9 Pallister, B. 2006. "Canada: Competing to Win." Report of the Standing Committee on Finance, December 2006.

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